



**Submission to the Productivity Commission: Business Set-up,
Transfer and Closure**

March 2015



IPA INSTITUTE OF PUBLIC
ACCOUNTANTS
Partnership beyond numbers

Forward

The Institute of Public Accountants (IPA) welcomes the opportunity to present our submission to the Inquiry into Business Set-up, Transfer and Closure.

The IPA is one of the three professional accounting bodies in Australia, representing over 35,000 accountants, business advisers, academics and students throughout Australia and in over 80 countries worldwide. The IPA prides itself in not only representing the interests of accountants but small business and their advisers.

The IPA takes an active role in the promotion of policies to assist the small business and SME sectors, reflecting the fact that two-thirds of our members work in these sectors or are trusted advisers to small business and SMEs. The IPA also pursues fundamental reforms which will result in easing the disproportionate regulatory and compliance burden placed on small businesses.

Australia has an enviable growth record but is facing some significant economic policy challenges, including an ageing population, slowing productivity growth, a mining boom that has reached its peak and rising unemployment. A strong and vibrant small business sector can play an active role in contributing to the economic growth of the Australian economy and help in addressing some of these challenges.

The IPA is accordingly very strongly of the view that immediate and tangible incentives must be offered to entrepreneurs and innovators to encourage their entry into and long term engagement with the Australian small business sector. The Federal Government needs to implement policies that will drive business activity and entrepreneurialism across all sectors.

Our submission draws heavily from the Australian Small Business White Paper which has been developed by the IPA with Deakin University. A draft copy of the White Paper has been provided to the Inquiry team, containing a full list of references and sources. The White Paper is currently being finalised.

If you have any further enquires then please contact Vicki Stylianou, Executive General Manager, Leadership.

Yours faithfully

Vicki Stylianou
IPA Executive General Manager, Leadership

Introduction

Whilst it is a widely held view that entrepreneurs are largely motivated by the desire to maximise profits, and hence their incomes, the body of empirical evidence suggests that there are many other non-pecuniary motives for running ones' own business (Taylor, 1996). Thus it might be more appropriate to consider the entrepreneur as someone who seeks to satisfy a minimum income threshold, whilst also deriving utility from independence and control over ones working time and arrangements (Eisenhauer, 1995; Taylor, 1996; Cowling and Mitchell, 1997; Douglas and Shepherd, 2000; Evans and Shepherd, 2002). These considerations hold even for established entrepreneurs. This is why Henley (2004), in a longitudinal study of UK self-employment, found that there was a very high level of state dependence in self-employment compared to waged employment. That is to say that once an individual starts their own business, their preferred option is to remain in charge of that business unless they are forced out of the market. Yet this feature of entrepreneurs can also be harnessed by policy-makers if it can be shown that government initiatives to support small businesses have the potential to improve their long-term capacity to survive.

Strategic focus

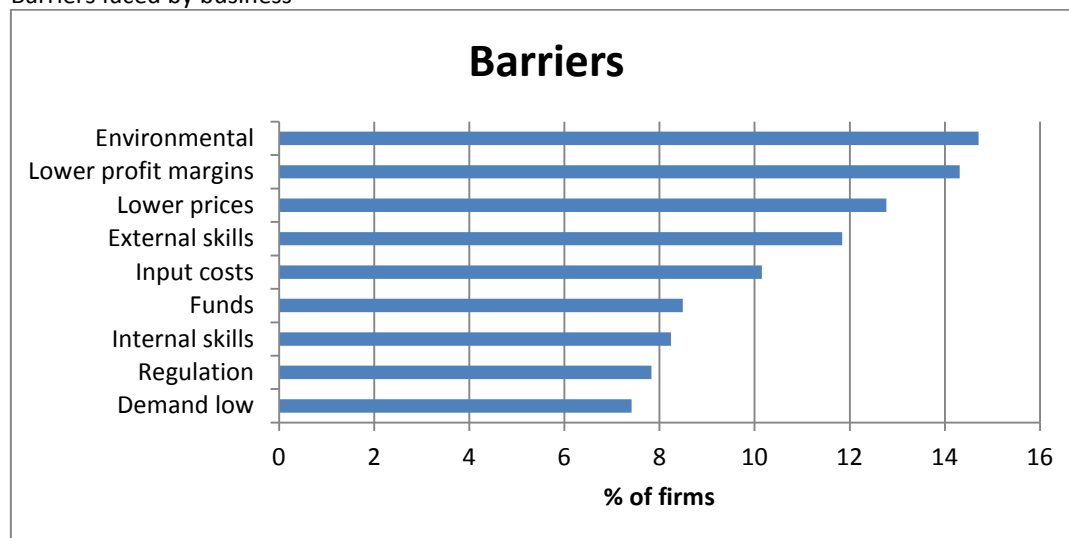
The Australian Bureau of Statistics Business Longitudinal Database 2006-07 to 2010-11 shows that less than half of all businesses place major strategic importance on financial measures, and this proportion diminished from 2007 to less than one in four by 2011. However, there has been an increasing strategic focus on costs over time which suggests that profit margins may have been under pressure. Quality is an important strategic focus, but its importance has been diminishing over time. Innovation is only of major importance to 1 in 7 Australian businesses. Operational measures, often an indicator of micro level productivity, have been increasing in importance over time, but are still only a major focus for 1 in 4 businesses.

There are important sector differences in performance too. For example, it was comparatively less likely that agricultural, mining and transport industry firms were able to deliver sales growth. And the poorest productivity performance was found in agriculture, transport and real estate. Going forward the relative lack of expenditure on training and IT suggests that the retail, hotels & catering, transport and real estate sectors of the economy are likely to find it more difficult to achieve productivity gains.

Barriers to business

A good indicator of where government might focus its attentions is given by business themselves when reporting on the barriers they face to their ongoing survival and development. The most significant barrier identified by Australian business is related to issues associated with environmental regulation. This is a concern for 158,000 businesses. The second most important barriers relate to the general state of the economy, and the cost pressures brought about by an increasingly competitive business environment. Labour market issues, particularly relating to the general level of skills in the labour force available for employment, rank as the third most important general barrier, although firms' internal capabilities were also found to be an issue of concern. The availability of funding from capital markets was the fourth most important concern, and was an issue for 180,000 businesses. In contrast, regulatory barriers were a relatively minor concern for the vast majority of Australian businesses.

Barriers faced by business



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

The evidence on barriers largely corroborates our other evidence, that is, the most important barriers reflect the overall decline in the economic environment, more competitive pressures and the struggle that many businesses are facing to increase their productivity and remain competitive.

Financial markets and access to debt capital

Headline findings

- The rationales for public intervention to improve SMEs' ability to access private financing are twofold. First, the spill-over hypothesis argues that SMEs are able to generate positive externalities by creating new jobs, new ideas, and new abilities that other industries and the economy as a whole may enjoy. The second rationale for government intervention is the existence of market failures, such as the presence of asymmetric information in terms of adverse selection and moral hazard
- On average, 28,000 Australian businesses per annum face a binding finance constraint, whilst 118,000 face some access to finance issues
- The focus of investment has shifted from investments in new productive capacity and efficiency enhancing towards more basic survival and liquidity related expenditures
- By comparable international standards the cost of debt is high
- Australian lending banks are cautious in their general lending policies and that risk-adjusted lending is not the norm
- Our recommendation is that a loan guarantee scheme is justified, on a modest scale, for a trial period
- External equity is of particular relevance for those high growth/high potential, young businesses, where the current revenue capability cannot sustain a guaranteed payment of loan interest thereby ruling out debt finance
- But there is a real danger that equity market pump-priming by the state translates into a permanent arrangement, with private investors happy to leave the onus and challenge of early-stage investing to the public exchequer. Legal (statutory) prevention of the government from becoming a cornerstone investor addresses this concern
- Governments with a strong commitment to economic growth via R&D investment facilitating greater enterprise and innovation activity are faced with a direct choice. They must find a means to ensure that early-stage venture capital (VC) finance remains available to high-potential, young firms or risk a reduction in the new commercialisation opportunities stemming from national investments in science and technology

Introduction

The subject of financial constraints or credit rationing has been the focus of a considerable body of theoretical work, and the existence of credit rationing has been examined extensively (Berger and Udell, 1992; Cowling, 2010; Goldfeld, 1966; Jaffee, 1971; King, 1986; Slovin and Slushka, 1983; Sofianos et al., 1990). Previous literature generally focuses on the supply-side of the credit market and assumes that information based problems discourage banks from advancing as much credit as entrepreneurs with potentially viable investment opportunities demand, even when they are willing to pay more for these loans (classic Stiglitz and Weiss, 1981, credit rationing). This supply-side ‘funding gap’ has been excessively used to justify government intervention to increase lending, regardless of the creditworthiness of borrowers (De Meza and Webb, 2000; Nightingale et al, 2009).

The negligence of demand-side constraints in small business financing has resulted in our fairly limited understanding on the extent of ‘true’ credit rationing (Levenson and Willard, 2000). Information asymmetry between lenders and borrowers may not necessarily lead to under-investment. Particularly under certain assumptions, the unobservable quality of entrepreneurs may indeed result in investment exceeding the optimal level (De Meza and Webb, 1987, 2000). On the other hand, informed financiers screening firms that are not commercially attractive out of the loan market may actually be rational behaviour indicating an efficient market. In this sense, some firms are simply not ‘investment ready’ (Mason and Harrison, 2001). Conceptualising the small business finance problem from both supply and demand sides would produce a more systemic framework for developing future entrepreneurial policy. This more holistic market perspective would draw attention to the simultaneity problems associated with building a funding system of many complex component parts (Nightingale et al, 2009). The current economic environment and the high uncertainty and complexity inherent in it provide a unique context to investigate the co-ordination of supply and demand and its effect on the SME financing market.

Loan supply

The majority of SMEs rely on internal sources of funding such as personal savings or retained earnings to fund their investment and only a small proportion have tried to obtain finance from external sources (Cowling et al, 2012; Fraser, 2005). However, the supply of external finance to SMEs differs fundamentally from larger firms,

in the sense that private debt and equity markets are the only markets SMEs have access to, whilst larger firms have access to both private and public markets. As suggested in their seminal work on small business finance, Berger and Udell (1998) conceptualised the supply of capital as a dynamic process which changes given SMEs' needs and options, as well as the degree of information opacity between firms and fund suppliers. In this sense, internal funds, trade credit, and/or angel finance are used more appropriately for seed and start-up firms with little finance need, while early-growth firms have more access to venture capital and bank finance, and finally private equity is more suitable for firms with sustained growth and the highest capital needs. However, a central tenet of Berger and Udell's model is the inter-connectedness between different sources of finance on a size/age/information continuum, and sources of funding may be substitutes or complements, thus creating a 'funding escalator' from business formation to a successful market exit.

The most common source of external funding for SMEs is commercial (high street) banks (Colombo and Grilli, 2007; de Bettignies and Brander, 2007). Yet not all SMEs that apply for external credit are successful (Fairlie and Robb, 2007; Levenson and Willard, 2000; Shen, 2002; Cowling, Liu and Ledger, 2012). This occurs for many reasons including lack of asset cover (Coco, 2000), poor information flows giving rise to moral hazard and adverse selection issues (Diamond, 1984; Myers, 1984; Myers and Majluf, 1984), non-viable projects, poor management teams, and exogenous factors such as unfavourable economic conditions. The issue of 'unfair' credit rationing that is not based on borrower quality (Stiglitz and Weiss, 1981), has been the focus of a large volume of literature (Cowling and Mitchell, 2003; Fraser, 2009), and has been used to justify government intervention in the form of loan guarantee programs (Cowling and Clay, 1994; Cowling, 2010; Riding, 1997; Cowling and Siepel, 2013). The counter-argument is that banks are rational and efficient processors of information, given their sophisticated data and information processing systems and hundreds of thousands of SME account histories, is made by de Meza and Southey (1996) and de Meza (2004) who argue that over-lending is more typical of the SME credit market. Thus, for firms with high levels of information opacity and concomitant agency problems, equity is a more appropriate form of finance especially for high-growth, high-risk new ventures (Berger and Udell, 1998; Gompers and Lerner, 1999, 2001a, 2001b; Keuschnigg and Nielsen, 2003, 2004; Mason, 2009; Maier and Walker, 1987).

Loan demand

In a perfect market, enterprise value should be independent of the capital structure chosen (Modigliani and Miller, 1958). However, the capital market is far from perfect and firms have varying preferences over different forms of external finance either due to tax considerations or information asymmetry (Myers, 2001). Since external finance is not costless, firms with financing needs will primarily first consider using internal sources of funds and only turn to external sources when internally generated funds cannot satisfy the firm's capital requirement (Myers, 1984; Myers and Majluf, 1984). With regard to external finance, given the tax deductibility of interest on debt, managers tend to take advantage of this tax shield until the benefit is fully offset by the possible cost of financial distress or credit down-grading caused by higher leverage levels (MacKie-Mason, 1990; Graham, 1996). This trade-off theory is supplemented by the pecking-order theory (Myers, 1984; Myers and Majluf, 1984) based on the information asymmetry between investors and firm managers. According to this theory, debt is preferred to equity because new equity issues, which would denude shareholders' ownership of the firm, could be taken by potential investors as a signal that the existing stock is overvalued (Asquith and Mullins, 1986; Dierkens, 1991; Eckbo, 1986; Shyam-Sunder, 1991). Therefore, investors with inferior information would require a higher return for equities. However, this sequence could be reversed if instead the informational advantage is on the investor side, especially in the case of entrepreneurial finance (Garmaise, 2000).

The demand-side counterpart to this supply-side body of literature focuses on the small business financing life-cycle (Berger and Udell, 1998) and essentially relates age, size, and information availability to usage of more sophisticated forms of capital alongside a continued demand for short and medium-term bank loans. The focus is then on how entrepreneurs can overcome these information problems by building relationships (Bester, 1985; Behr and Gutler, 2007; Petersen and Rajan, 1994) or, in the absence of relationships, by offering collateral as security against loans (Coco, 2000; Cowling, 1999; Leeth and Scott, 1989). Given the widespread agreement that lack of credit can restrict the ability of entrepreneurs to invest and that this can reduce rates of innovation, job creation and other positive economic externalities, it is perhaps surprising that relatively little attention has been paid to the determinants of the demand for credit from the entrepreneurial sector.

In line with classic credit rationing theories, when loans are not forthcoming to entrepreneurs with viable investment opportunities then lending is at a sub-optimal level and banks suffer from lower profit, some of which could be used for future lending. On the demand-side, when entrepreneurs with viable investment opportunities do not access loans which they would have received, then there is a sub-optimal level of investment (under-investment) from the entrepreneurial sector, and this can result in lower returns to entrepreneurial ability (human capital) at the micro level and lower rates of innovation, fewer jobs created, and generally lower levels of economic growth at the macro level.

In the context of our report, what happens in the market for small business finance when an economy is showing signs of an impending productivity slowdown, is of great importance. Lown and Morgan (2006) show that the credit cycle and the business cycle act in opposite ways as far as loan supply is concerned. They conclude that credit standards are more informative about future lending than are loan rates, i.e., loans are rationed via changes in credit standards not loan rates. In a related paper, Hanousek and Filer (2004) argue that the way that banks allocate loanable funds is the main cause of credit rationing for small firms, as investment generally flows to industries (not explicitly firms) with the greatest profit potential.

Thus there appears to be a gap in our knowledge in terms of what really happens to SMEs' lending from the demand-side (as well as a supply-side) when an economic slowdown occurs. This is important as loan applications are not costless and involve collating financial information and formalising an investment focused business plan with cash-flows forecasts and revenue projections. Further, these costs are likely to vary substantially across entrepreneurs, with relatively inexperienced entrepreneurs incurring the highest application costs. Thus we focus on the demand for credit from entrepreneurs and how this is affected by dynamics on the supply-side of the credit market. This is outside the more traditional focus of credit rationing theories, which primarily focus on the lenders' (suppliers of credit) inability to accurately assess (entrepreneurs) risk due to information problems.

Rationale, practices and effectiveness of government support initiatives

Lerner (1999) suggests that the rationales for public intervention to improve SMEs' ability to access private financing are twofold. First, the spill-over hypothesis argues that SMEs are able to generate positive externalities by creating new jobs, new ideas, and new abilities that other industries and the economy as a whole may enjoy (Cressy and Olofsson 1997; Cressy, 2002; Lerner, 1999). The second rationale for government intervention is the existence of market failures, such as the presence of asymmetric information in terms of adverse selection and moral hazard (Hyytinen and Väänänen, 2006). Thus, the availability of risk capital for small and highly innovative companies, young enterprises, and firms located in depressed areas has been a key policy issue for the government in order to promote not only the growth of these SMEs, but also the whole economy (Lawton, 2002).

In terms of the difficulties that SMEs face in accessing debt capital and given the commonly existing credit rationing in the small firm loan market (Cowling and Mitchell, 2003; Honaghan, 2008; Klapper et al., 2006; Riding, 1998), (partial) credit guarantee schemes are the most widely used, and long-standing, public policy supporting mechanism worldwide (Cowling and Siepel, 2013). The objective of such schemes is almost unanimously to provide loan security to SMEs, which would not otherwise be able to obtain debt finance through conventional means (Cowling and Clay, 1995; Riding, 1998).

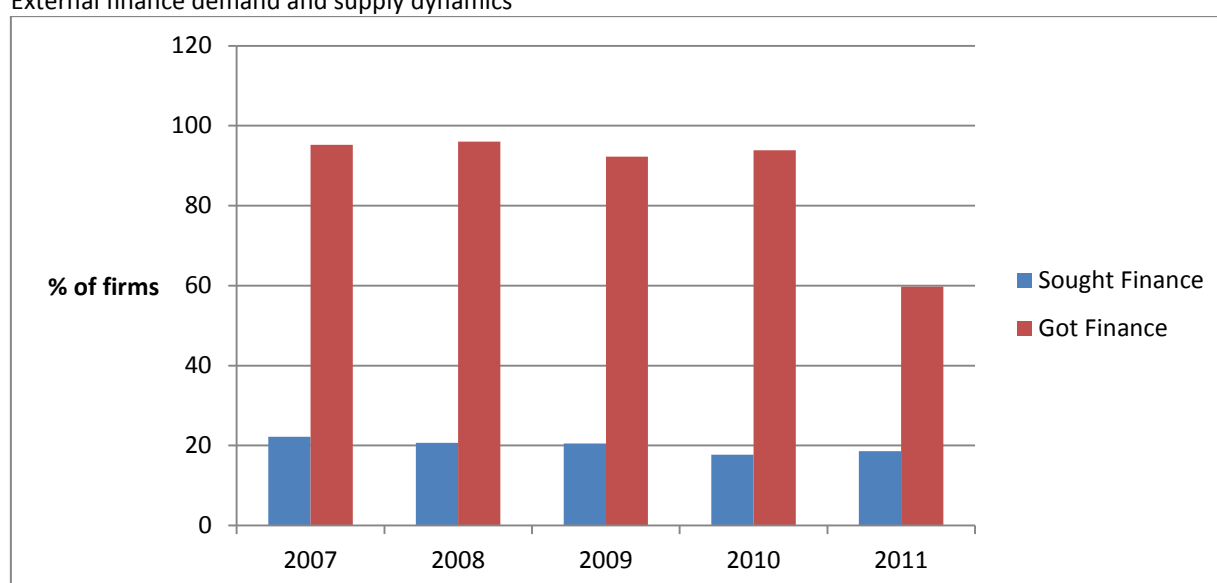
In terms of the UK experience, the Small Firm Loan Guarantee (SFLG) program has been the Government's primary debt finance instrument over the past three decades until it was replaced by the Enterprise Finance Guarantee (EFG) program in 2009. The EFG was introduced as a Government response to the global financial crisis in order to improve the availability of capital to a wider range of businesses and a recent evaluation found positive effects (Allinson, Robson and Stone, 2013). Meanwhile, the aim of the SFLG was to assist viable, debt-appropriate businesses that lack sufficient collateral to access loan finance in the market (Graham, 2004). Generally speaking, empirical evidence suggests that the rationale for public intervention is justified (Cowling and Mitchell, 2003; Cowling and Siepel, 2013) in the sense that SFLG has allowed certain types of small firm borrowers to access bank funding and/or improved supported firms' performance.

Financial markets and access to equity capital

Smaller business and financial markets in Australia

We now turn our focus to the demand for and supply of external finance to smaller business in Australia. The first issue we focus on is the demand for finance. Here we observe that at any point in time, only 1 in 5 businesses (representing around 400,000 Australian businesses per annum) are seeking external funding from the market. This is in line with evidence from other developed economies (Cowling, Liu and Ledger, 2012), which shows that the dominant (or preferred) source of external finance is bank lending.

External finance demand and supply dynamics



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

On average, only between 7% and 8% of businesses seeking external finance are unable to secure funding from external markets. This is 'typical' for developed economies in periods of economic growth. There is a distortion in the ABS Business Longitudinal Database figures for 2011, however, as a much larger number of businesses sought equity finance, which has a significantly lower success rate than debt finance. So, on average, 28,000 Australian businesses per annum face a binding finance constraint.

The important public policy question is whether or not these constrained businesses are of poor quality and hence are too risky to invest in, or whether they are constrained for non-quality based reasons such as lack of assets to place as security or lack of a sufficiently long track record. The former implies no role for public policy

and is simply an indicator of the market operating efficiently and sorting out the 'good' from 'bad' propositions. The latter implies unfair rationing and a case can be made for public policy intervention to correct for a market failure.

The most widely used, and long-standing, public policy mechanism worldwide for supporting small firms is the (partial) credit guarantee scheme. Well established examples of these schemes include the SBA 7(a) loan program in the US, founded in 1953; the Canadian core guarantee program (CSBFP), founded in 1961; and the UK Small Firm Loan Guarantee program, founded in 1981. A World Bank guarantee scheme survey by Beck, Klapper, and Mendoza, (2008) identified loan guarantee programs in a total of 46 different countries across the world including France, Germany, Sweden, India, Korea, Indonesia, and Macedonia. We note that Australia is unique in the developed world in that it has no guarantee scheme.

Exploring these 'ability' issues further, we can consider a regime in which there are 'poor' and 'rich' borrowers. But it is questionable whether entrepreneurial talent is the prerogative of the wealthy or more broadly distributed throughout the population as a whole. Without reasonable access to financing, many talented entrepreneurs may be forced to accept waged employment and contribute less to the economic system. Innovation and business development will become a luxury reserved for the wealthy, and the economy as a whole will suffer (Hanson, 1983).

But entrepreneurial talent is not possessed by all in the population and it is largely unobserved (Ghatak et al., 2002). Thus credit rationing is largely influenced by events in other markets, in particular the labour market. As wages affect occupational choice, this fundamentally determines the quality of a bank's borrower pool (Taylor, 1996), which affects lending policy. Efficiency requires that talent, not wealth, which should determine who becomes an entrepreneur (Cowling et al., 2003). There are three potential outcomes for talented entrepreneurs where banks have high collateral requirements.

- talented entrepreneurs with full collateral only apply for loans and get separating contracts (i.e., the price of a loan reflects the specific risk of that firm or project)
- talented entrepreneurs with not enough collateral get pooling contracts (i.e., high quality borrowers in the banks' portfolio effectively subsidise lower quality borrowers whose loan price does not fully reflect their relative risk)

- talented entrepreneurs with no collateral get rationed

It is this latter outcome that represents a market failure that requires public policy intervention to prevent an overall loss of economic welfare.

Crowdfunding

From a policy maker's perspective, two issues dominate contemporary discussion. How do we encourage a major new activity that directly addresses the financing of entrepreneurial activity? At the same time, how do we stop this new activity being a license for con-men and grafters to prey on the stupid and the gullible? The Jobs Act in the US gives greater freedom for crowdfunding activity. However, equity based schemes in the UK and the USA are still regulated, i.e., schemes similar to VC/Business Angel deals. According to the FCA, most UK legislation is out of date and is poorly adapted to deal with the challenges of Crowdfunding (Financial Conduct Authority (UK), 2013 ref CP13/13).

The Government has announced a policy on crowdfunding and we note the release of the *National Industry Investment and Competitiveness Agenda*. Upcoming consultation is meant to endorse the concept of crowdfunding but will also propose restrictions on how it works, including caps on the amount that can be raised and the amount an individual can contribute." The advice, from the Corporations and Markets Advisory Committee, also recommended that individuals should not be allowed to invest more than \$10,000 in crowd-funded ventures each year, suggesting this be rationed to \$2,500 across four companies." This ambiguity has resulted in one Australian company, Equitise, launching its crowdfunding service in New Zealand where existing legislation and regulation is more conducive to these activities.

Putting a 'cap' on individual contributions may not frustrate crowdfunding as the logic is that many small investors combine their payments to create significant sums of money. However, unlike VC or BA finance, this provision of finance remains to the totality of investors' contribution. No advice can be imparted in this model. And, indeed, the investors are likely to have any advice to proffer.

The reality is that we are all in unknown territory with this novel form of entrepreneurial finance. The remainder of the decade will be a very steep learning curve as to crowdfunding's strengths and weaknesses.

For Pebble 'gizmos' and supporting the manufacture of 'realistic' female teen dolls that are an antidote to Barbie (see <https://www.lammily.com/>), i.e. products that catch the public's fickle imagination, crowdsourcing has been almost a magical intervention. Whether this can translate into a credible and sustainable source of entrepreneurial finance for attractive young enterprises across the sector, product and service spectrum remains to be seen.

Why is government interested in venture capital?

Venture capital as a policy instrument for promoting high-growth enterprises has almost universal appeal to governments across both the developed and developing world, regardless of political colour (Lerner, 2009). The reason for their enthusiasm is simple: venture capital, despite its well-publicised difficulties, is seen as a critical component of a modern enterprise economy. It is particularly associated with the identification and support of young new-knowledge/new-technology firms with the potential to bring about major disruptive changes to markets and their users, and thus spur innovative and economic progress (Hellmann and Puri, 2000; Lerner and Khortum, 2000).

Why is venture capital difficult?

Private equity (PE) most frequently deals with established companies working in known industries producing 'mature' products and services both widely purchased and understood by their customers. For the early-stage VC investor, little of the above is true. VCs commonly support new enterprises in 'new knowledge-based' areas of science and technology where the returns to successful companies can be extraordinarily high. In order to exploit such novel and emerging opportunities, the investors and the supported entrepreneurs and managers have to operate in markets and sectors with enormous levels of uncertainty regarding the technology, and the feasibility and attractiveness of the novel products and services produced.

This uncertainty is further compounded by the frequently untested nature of the entrepreneurs and his/her management team. Even successful products may quickly become obsolete as a result of rapid technological advances. Many of the entrepreneur founders involved may be commercially untested despite their exceptional technological or scientific skills. Seasoned VC investors have even argued that they would prefer to

support a first class management team with a problematic business idea rather than vice versa.¹ Thus, the experienced venture capitalist has to be skilled at both recognising opportunity and being able to nurture young enterprises, which includes coaching their founders and managers to achieve a successful, valuable commercial entity (Sapienza, 1992). Such commercial, analytical and mentoring skills (i.e., human capital resources) leading to a successful venturing track record are scarce, even in the most advanced economies.

Market failure in early-stage venture capital markets

Liberal western economies seek to leave markets to their own devices unless there is clear evidence of serious and harmful market failure (Rigby and Ramlogan, 2013). As Gilson (2003) notes, the VC market demonstrates a trinity of *simultaneous* problems, i.e. uncertainty, information asymmetry and opportunism. The resulting agency costs and ‘moral hazard’ problems increase the difficulty of the entrepreneurial transaction. While venture capitalists can reduce ‘agency costs’ by the imposition of clear governance procedures designed to accelerate the commercialisation process (Cornelli and Yosha, 2003), inherent conflicts between the interested parties still remain.

These problems stem from the reality that much early-stage VC activity is associated with emerging and immature technologies and the new opportunities they (might) signal. However, these signals are often noisy, frequently misleading and their communication is problematic. Technology entrepreneurs may know more than the professional investors engaged in their projects. This disparity can produce serious information asymmetries. Entrepreneurial owners’ partial disclosure is likely to be influenced by their own interests. Venture capitalists will wish to protect their economic position as an intermediary against both the providers of their finances (institutional investors) and the entrepreneurial founders of the ventures which they back. Profound levels of uncertainty are coupled with the critical fact that the majority of early stage venture activity – and particularly venture activity in new technologies – has frequently resulted in disastrous returns for many early-stage VC investors. In turn, this has prompted a general trend since the early 2000s with many institutional investors moving away from significant involvement in such a highly speculative asset class (EVCA 2013).

¹ Quote from US pioneer VC, Arthur Rock.

Government responses to 'thin' venture capital markets

This industry-wide migration of investors from early-stage VC to later stage and less risky Private Equity (PE) since the late 1990s (Cumming et al., 2009) has reduced a critical supply of growth capital to young technology and/or 'new knowledge' based firms. For such firms in their early days of development, bank finance with its requirement for predictable cash flows, is not relevant or helpful (Bettignies and Brander, 2007; Keuschnigg and Nielsen, 2002). High-growth firms will also rapidly outgrow the financing of family and friends and often the limited availability of Business Angels (BA) finance (Ruhnka and Young, 1987) although, as noted, BA syndicated resources are increasing.

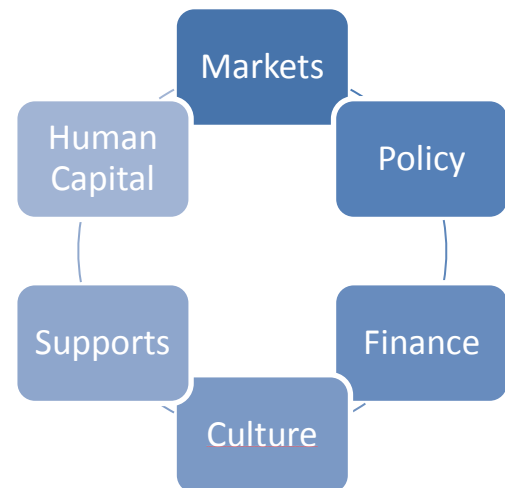
Governments with a strong commitment to economic growth via R&D investment facilitating greater enterprise and innovation activity are faced with a direct choice. They must find means to ensure that early-stage VC finance remains available to high-potential, young firms or risk a reduction in the new commercialisation opportunities stemming from national investments in science and technology. In a world of international scoreboards in innovation, enterprise, etc., few advanced economies wish to see VC disappear from their borders to the detriment of their highest potential firms (Wilson and Silva, 2013). They are likely to lose their best firms to countries with a more benign environment for start-ups and early growth firms.²

Entrepreneurial ecosystems

In order to engender a viable and sustainable entrepreneurial ecosystem, the provision of early-stage venture capital finance to identify, nurture and exploit exceptional entrepreneurial opportunities should be recognised as a 'necessary but not sufficient' condition. The 'entrepreneurial ecosystem' (Napier and Hansen, 2011; OECD, 2013) also needs to ensure the presence of a complementary range of related conditions (Lerner and Tag, 2012), including supportive legal structures, education, fiscal and cultural environments.

² One Australian policymaker observed after meeting young Australian companies that had started in the US, rather than Australia, because of its closer links to both customers and resources. Many French entrepreneurs have migrated to London in recent years given the disparity in policies supporting new enterprise in France and the UK.

The entrepreneurial ecosystem



Source: Isenberg (2010), Gordon Murray and DAMVAD

It is a tell-tale sign of an inexperienced government when the considerable challenges of financing young and growing enterprises are seen as fully accommodated by the single introduction of a government co-financed VC program.

Work by the Kauffman Foundation and academics (Isenberg, 2010) shows that a VC program can only operate effectively if the environment encouraging and supporting new and growing enterprises exists and is active. Legal (Cumming et al., 2010; Yong et al., 2012) and institutional structures (North, 1990; Busenitz et al 2000), fiscal incentives to entrepreneurs and investors, education, the communication effects of networks and clusters, and the popular cultural view of entrepreneurs each play a role in what is increasingly and widely termed the 'entrepreneurial ecosystem'.

Understanding 'competitive advantage'

Venture capital can be defined as the identification and realisation of exceptional (i.e., world class) businesses nurtured and grown from their young enterprise roots. VC is also strongly associated with new knowledge/technologies and novel scientific applications applied to goods and services with international, if

not global, market appeal. In summary, VC selection is about excellence and meritocracy. Usually the best managers and the best technologies win in competitive markets. Accordingly, a VC program needs to identify critical and internationally competitive clusters of resources of innovation and intellectual human capital present in and/or accessible to the target economy. Such inputs form the basis of exceptional business opportunities and ultimately the creation of excellent new enterprises. In essence, the existence of a high quality deal flow is pivotal in the success of any (and every) VC program. In the language of business schools, and supported by the work of Harvard's Michael Porter (1990), nations, like businesses, need a 'sustainable competitive advantage'. Finance and technology are two of the most globally mobile factors, and the worldwide search for opportunities for capital or technology attests to this fact.

Planned program redundancy

The purpose of having a publicly-supported VC fund is to improve the entrepreneurial environment, to train practitioners and users as to the advantages of risk capital, and to act as a catalyst in identifying and overcoming hurdles to successful and profitable investment. The purpose of the state's involvement is not to substitute for commercial providers of risk capital in the long term. Accordingly, over time, there should be clear evidence of a reduction in the relative commitment of public finance as a maturing market becomes colonised by fully commercial providers. Co-financing schemes should (at best) only temporarily condone public financing being greater than 50% of total program funds committed. The ultimate aim of publicly-supported enterprise finance program should remain that of a planned redundancy of state intervention.

The concept of 'pump priming' implies appropriate and *temporary* intervention. It further assumes identifying operational barriers (e.g., experience, skills, networks, etc.) that can be addressed and then overcome. Yet, the reality is that for programs of sufficient size to have a material effect on the markets in which they intervene, governments are likely to become long-term participants rather than temporary visitors. This 'white knight' situation of temporary intervention, correction and then retirement of the program appears extremely rare. The most commonly cited example of a successful temporary intervention by government is the famous Yozma program (1994–1997) in which eight of the ten publicly-co-financed Israeli VC funds were rapidly sold to their VC managers at a USD 100m profit to the Israeli exchequer in less than three years (Avnimelech and Teubal,

2004; Erlich, 2001). *Yozma is repeatedly cited, despite being twenty years old, particularly because such a successful and brief public intervention into VC is so rare.*

There is a real danger that pump-priming by the state translates into a permanent arrangement with private investors happy to leave the onus and challenge of early-stage investing to the public exchequer. Mindful of this danger, the UK's Capital for Enterprise Board was legally prevented by its statutes from becoming a cornerstone investor. CfEB could only invest *after* private investors had provided sufficient monies to make the new fund a viably sized entity with CfEL's assistance. Such a prescription has the effect of ensuring that government does not colonise part of the capital market where there is no commercial interest from private and commercial interests in creating or sustaining such an activity. In the protracted absence of private investors, governments do need to be very sure as to why their own intervention is justified. A 'market failure' argument may not be credible. The fact that professional investors do not choose to invest in enterprises that will not return a profit commensurate with risk and illiquidity incurred cannot *per se* be seen as a market failure.

Building an innovation system

Headline findings

- Around 10% of Australian businesses produce innovative goods and services
- Between 16% and 21% innovate in their underlying business processes
- Capturing value and diffusing existing innovations through-out the economy are the key issues to address when designing innovation policy
- Even if Australian SMEs are not the initial investors or innovators, they can still capture some of the value of innovations developed elsewhere
- New-to-the-country, and particularly new-to-the-firm, innovations are often more economically important for improving national productivity. Innovation policy should include measures to encouraging the diffusion and uptake of existing innovations to a broad range of firms, as well as encouraging new innovations
- Firms that can adopt “continuous improvement” methods to embed incremental innovation can generate large productivity improvements
- There appears to be a very low incidence of co-operative behaviour in the Australian business sector, typically less than 1 in 10 business co-operate on any level, and this could be a major barrier to innovation, and more generally to productivity growth
- Large firms often find it hard to change their business model to capture value, but SMEs can change them more easily. Public policy to support innovative SMEs should increasingly take into account value capture and business model innovation more generally. This includes ensuring regulations help firms to capture value while balancing the benefits other firms receive from the wider diffusion of value
- Businesses in Australia experience a wide range of barriers to innovation, with no one barrier dominating. This suggests policy to support innovation needs to be flexible and broad based
- Talent not technology is the key. Without addressing wider skill requirements, research show it is likely to create bottlenecks downstream in the innovation process. Technical skills across the workforce, and particularly interdisciplinary skills that bridge areas of expertise, are particularly important for innovation and are often subject to market failures

Introduction

Innovation is widely regarded as a key driver of productivity growth, job creation and superior economic performance. At a firm, sector and national level, higher levels of innovation are associated, both directly and indirectly, with superior economic performance.

Despite the importance of innovation, it is often misunderstood. There is a tendency to equate innovation with high tech manufacturing, and it is assumed that it is something that only happens in R&D labs. However, only around 3% of firms are high tech, and many firms innovate outside formal R&D. Financial services, for example, have very low measures of R&D intensity, despite being highly innovative. While not all Australian firms are innovative, Figure 25 shows that significant numbers of Australian firms, roughly 10%, produce innovative goods and services. Moreover, many more (between 16% and 21%) innovate in their underlying business processes. These percentages are higher than the percentage of high tech firms observed in the Australian economy, highlighting the need for a broader understanding of innovation, to provide the foundation for effective SME policy (Nesta, 2006).

The ability to start and develop a sustainable business is fundamentally related to the internal capacity and capabilities of the entrepreneurial team, top management, but also to that of the core workers (Cowling, 2001). And for smaller businesses, with a greater probability of being credit constrained and under-capitalised, their human capital capability takes on a more prominent role as firms are more likely to adopt labour intensive modes of production. To this end, the ability to successfully recruit and retain high quality workers at all organisational levels is paramount, as it is the skills embodied in these people that drive business capacity and capability (BIS, 2013). Human capital largely determines the level of absorptive capacity a business has, and hence its ability to effectively deploy different types of knowledge and resources. Detailed productivity analysis (Cowling, 2001) shows that there is an identifiable productivity enhancing effect from all levels of human capital in the firm from the founding entrepreneur, the board of directors, through the management team, and most importantly from the core workforce. Thus absorptive capacity is directly related to human capital (the presence of talented people) throughout the business.

From our 3 Pillars, we note that human capital is a fundamental driver of productivity in its own right. But in combination with innovation and physical capital its economic impact, through efficiency gains, is even larger. Poor internal skills are a key indicator of low productivity and high staff turnover. It also imposes additional costs to businesses by having to recruit externally rather than promote internally. In contrast, high skill levels are associated with higher productivity in a direct sense, and also with a productivity enhancing effect on other co-workers. In this chapter we present some evidence relating to skills demand in the Australian business sector and identify specific skills shortages. We argue that where businesses have a high demand for skilled labour, but are constrained by lack of internal and/or external skills, then this represents a prima facie case for government intervention. On the firm side, this may relate to training of their own workforce, and in the wider economy, this may include policies relating to education and training of the wider labour force. Training and skills development is widely cited as a classic case of market failure as individual businesses often cannot appropriate the full returns to their investments in these areas, and hence tend to invest at a sub-optimal level - below that which is socially desirable for the Australian economy. Further, information gaps and asymmetries can mean that employers do not fully understand the total benefits arising from training their workers. But perhaps the strongest argument for government intervention relates to the potential for positive spill-overs into the wider economy, as highly skilled workers move around employers, and disseminate their knowledge.

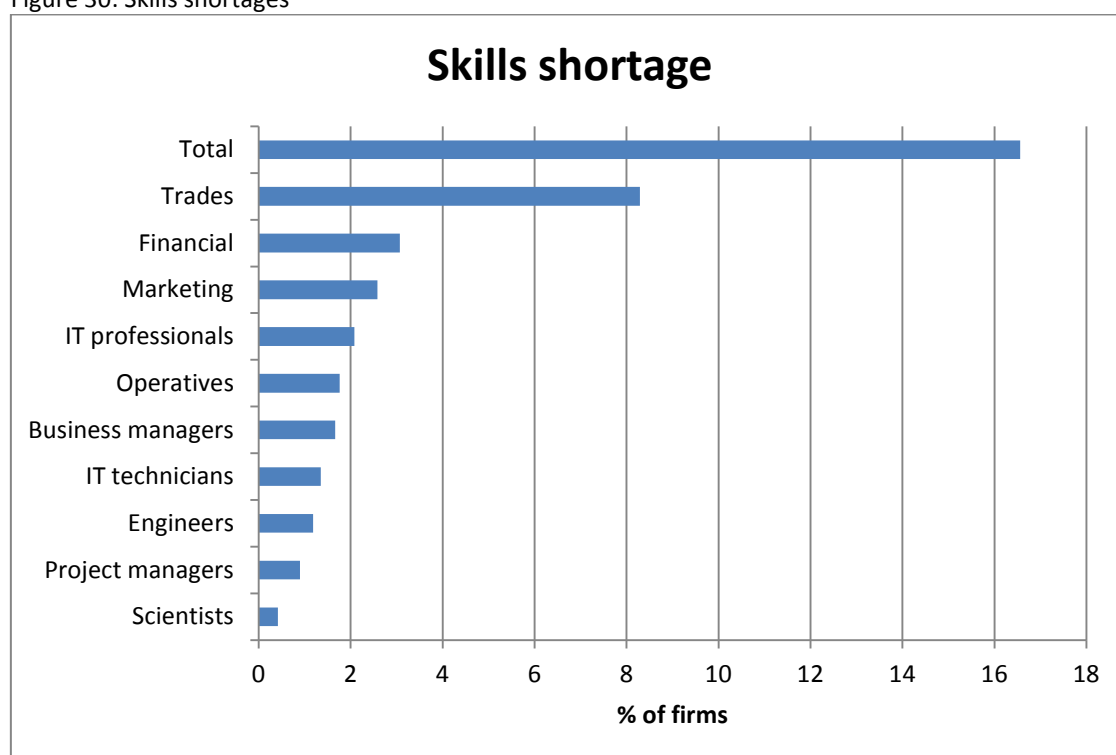
Skills demand and deficiencies

The evidence clearly shows that skills use is increasing by size of business, with one notable exception. The exception is for scientific and research staff, who play a more significant role amongst micro and smaller businesses, than amongst sole traders and larger businesses. The general pattern suggests that the smaller the business, the fewer skills deployed in the business. And this has important, and negative, implications for their absorptive capacity, and particularly their ability to deal with unanticipated shocks to their environment. But the evidence on skills deficiencies is quite different. Although, larger businesses (those with a higher use of skilled workers) also are constrained by a relative lack of engineers, IT professionals, skilled trades people, project managers and business managers, it is micro businesses who are more constrained by skills deficiencies

in relation to scientists and research professionals, IT technicians, marketing professionals, and project managers.

In aggregate, Figure 30 shows that 1 in 6 businesses in Australia face a problem around skills deficiencies. Deficiencies are most apparent in trades, but 64,000 businesses have an identifiable skills deficiency in relation to finance professionals, 55,000 businesses in relation to marketing professionals, and 44,500 businesses are deficient in IT professionals. This suggests that whilst the immediate labour market problem Australia faces relates to the construction boom and a lack of skilled trades people, the underlying problem might be in high value added professional services.

Figure 30: Skills shortages



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

Having considered general skills shortages and assessed how demand and supply for different types of skills varies across businesses of different size classes, it is important to also consider the nature of industry sector constraints. Table 1 identifies specific industry sectors where demand for a certain type of skill is high, but which also face an identifiable skills deficit.

Table 1: High skills demand and high skills deficit industry sectors

Industry sector	Skills deficiencies
Mining	Engineers, scientists and researchers, IT technicians, project managers
Manufacturing	Trades operatives, project managers
Construction	Trades operatives, project managers
Transport	Operatives
Communications	IT professionals, IT technicians
Professional Services	IT professionals, IT technicians

Source: ABS Business Longitudinal Database 2006-07 to 2010-11(authors calculations)

Here the picture is clear. The booming sectors of the economy have a strong demand for core functional workers, but the mining industry also has a high demand for highly skilled workers across the board. But perhaps the most interesting aspect looking forward is that the sectors we predict are going to be key sectors in delivering future growth and productivity increases, communications and professional services, have a high, and unmet, demand for IT workers at professional and technical levels. And more importantly, these are sectors characterised by high knowledge intensity and a disproportionately high smaller firm presence.

Boosting skills demand and supply

The key to resolving Australia's longer-term goal of creating a more dynamic and productive small business sector lies in boosting both skills supply and skills demand. In short, policy attention needs to focus on both sides of the skills market in order to create more quality jobs for more productive workers. In this sense, there is a need to;

- Co-ordinate employment, skills and economic development policy which aligns, to a greater extent, the labour market, training and economic policy
- Create a lifelong learning culture which delivers a workforce that is more adaptable and better able to transfer between firms and sectors as a dynamic and productive economy requires that resources (investment and people) flow to those areas of the economy that have the most productive potential
- Move out of a low skills trap where some sectors of the economy are stuck in a low-skills equilibrium where firms offer low-skilled jobs and operate in low-cost markets

- A key part of this is educating and training managers and entrepreneurs to stimulate demand for higher skilled jobs



And entrepreneurs have a major role to play given the centrality of entrepreneurial businesses in net job generation. But helping the entrepreneurial sector to achieve its potential requires policy support across many areas, including;

- Business growth support (initiating and managing growth)
- Core entrepreneurship skills
 - Business training
 - Skills development
 - Network building
 - Mentoring

Entrepreneurs need a wide range of skills including job specific and functional skills such as communication, team-working, organisational, planning, as well as more general business skills. Generic workplace tasks are increasingly important as the general trend is away from jobs that require routine and manual tasks towards jobs that require problem solving and complex communications. And this requirement for high level cognitive skills is more apparent for the entrepreneurial population. Importantly, the OECD (2014) report on “Job Creation and Local Economic Development, p.110” states that, ‘The ‘science’ of entrepreneurship is teachable but the ‘art’ of entrepreneurship is typically learned through practice.” This is of great importance given the dominant role that knowledge capital plays in economic growth and the role of entrepreneurs as agents of change of growth.

Importantly, the creation of an entrepreneurial ecosystem in which a system of support can deliver these skills to the entrepreneurial population, which in turn creates a demand for higher skilled employment, requires co-ordination across key agents including Universities, Economic Development Agencies, and firms themselves. The key advantage for a locality or country in terms of its ‘business’ offer is the quality of its human capital (entrepreneurs and workers). The OECD provides a useful categorisation of this interaction of skills demand and supply for use as a skills diagnostic tool.

Table 2. Interaction of skills demand and supply

<div>Skills Demand</div> 	Skills deficit	High skills equilibrium
	Low skills equilibrium	Skills surplus
	<div>Skills Supply</div> 	

Source: OECD (2014) Job Creation and Local Economic Development

Here a low-skills equilibrium is characterised by a concentration of firms using price-based competition strategies, reliant on low-skilled and standardised production. This would be a reasonable characterisation of significant parts of the domestic based service industries in Australia, particularly those segments dominated by very small firms.

Moving out of the low-skills equilibrium

For the entrepreneurial population, this would require the skills and capabilities to develop and implement new market based strategies. This, in turn, would stimulate demand for higher skilled workers. On the supply-side, the Skills Australia (2012) “Better Use of Skills, Better Outcomes” report identified seven key skills based issues that would deliver more productivity in the workplace. These are;

- Job redesign
- Employee participation
- Autonomy
- Job rotation
- Skills audits
- Multi-skilling
- Knowledge transfer

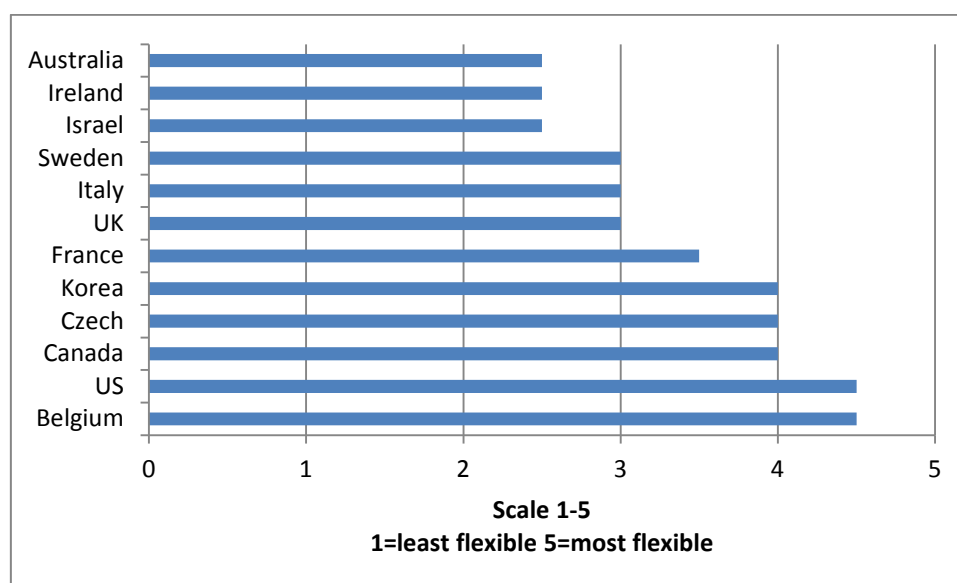
But, as with most Government policy, it is designed for, and in consultation with, large employers and large employee representative bodies. If implemented in a large employer there would be a period of consultation with employee representatives, the development of formal systems and processes, and lots of bureaucracy and additional costs. Many of these practices occur already, on an informal basis, in small firms by the very nature of their working arrangements and the workforce employed, not least the absolute number of people

employed within the business. But the evidence on the relative (lower) productivity of smaller firms compared to large suggests that these supply-side solutions are, at best, only part of a more complex solution.

So what about the role of institutions in resolving skills mismatches at the firm and sector level and where low-skills equilibria exist?

The OECD (2014) strongly supports the need for flexibility at the local level in designing and delivering policy and programs in the area of employment. Figure 31 suggests that Australia has adopted a top down, one size fits all, strategy in this area which does not allow for programs to take into account local labour market conditions and specific skills demand and supply issues. This could equally be applied to the unique issue of the relative low-skills equilibrium faced by significant elements of the small business sector. Here, the OECD recommends that policies and programs are adjustable at a 'local' level in terms of strategic orientation, program design, and performance and budget management. The one caveat being that this level of flexibility requires strong 'local' leadership and capacity.

Figure 31: Flexibility in the management of employment policies and programs



So can enterprise training in the education play a role?

The role of human capital has been central to our understanding of what makes an entrepreneur, and whether, or not, people who do choose an entrepreneurial career path are successful (Cowling, 2000; Cressy, 1996).

Researchers have separated out human capital into two broad categories, formal (essentially educational qualifications and experience), and informal (human capital developed through work experiences and familial experience), and questioned whether one or the other 'types' of human capital is more helpful in pursuing an

entrepreneurial career (Parker, 2008). Other, more philosophical, research has questioned whether entrepreneurship can be taught at all or whether it is an innate characteristic (see Lee and Wong, 2006, for an excellent review). Finally, the question as to whether enterprise education and training can make a difference to business outcomes has always been open to question and at present suffers from a lack of empirical testing. Whilst there is no definitive answer to any of these questions, the broad evidence base suggests that:

- Informal human capital is more important in the entrepreneurial sector than the waged sector (Cowling et al, 2004; Taylor, 1996; Burke et al, 2000)
- Psychological characteristics explain rather less about entrepreneurial behaviour than labour market experience and socio-demographic characteristics (Blanchflower and Oswald, 1998)
- Entrepreneurship has a formal, managerial and decision-making, element that lends itself to formalised teaching (Cowling, 2003), and opportunity identification is at the heart of this (Dana, 2001).

A key, UK study by Cowling (2009), explored the impacts of (a) enterprise training in schools, (b) enterprise training in colleges and universities, (c) work experience in small business, and (d) enterprise training on a Government program, on the probability of starting a new business, the probability of being involved in a spin-out from an existing firms, the probability of being an established business owner, and an individuals' willingness to start a new business in the future. The findings were illuminating, and provide support for an interventionist and broad strategy of policy in the area of enterprise education at all levels of the education system.

Business start-up

In terms of the probability of starting a new business currently, receipt of enterprise training in college or university increases the probability by 1.3%. In addition, receiving enterprise support through a government program increases the probability by 1.5%. These probabilities are statistically significant, but, equally importantly, they are substantial in the context of how many people actually start a new business each year in the UK. Take the annual outflow from higher education institutions each year. This outflow amounts to literally hundreds of thousands of young people each year. At present only a fifth receive enterprise training, and these people have a 1.3% higher probability of starting their own business. Thus we might conclude that an expansion of the supply of enterprise training throughout the further and higher education sector might yield a

substantial increase in the number of people involved in business start-up activity. However, there may be diminishing returns if colleges and universities have cherry picked those courses most likely to lead to entrepreneurial activity and careers, and focused their scarce resources on providing support to them. This question certainly appears worthy of further investigation.

In terms of access to government enterprise programs, again we note that the effect on business start-up probabilities is positive and significant. Amongst the adult population we found that total exposure was just under 15%, and peaked in the 1980s. But it still remains the case that many young people today receive government enterprise support. And this general legacy effect acts to increase the start-up probability across all age groups. This implies that a general, and continued, commitment to government supported enterprise programs has paid off in terms of increasing the number of people who are currently active in starting their own business. Whether the costs of such provision are justified by the additional economic activity is an issue for policy evaluation, but the basic premise is that policy intervention of this type has achieved its primary goal of increasing the business start-up rate.

Job related start-ups

Next we focus on what is loosely termed job related start-up activity in Global Entrepreneurship Monitor terms. This is akin to what business researchers often call intrapreneurship, or entrepreneurial activity within an existing firm. Economists might associate this with endogenous growth. It may subsequently lead to spin-out activity, but as it is measured here it simply relates to workers who are engaged in a new business activity as part of their normal job function. Here the report finds that college or university based enterprise training increases the probability that an individual will become involved in job related start-up activity by 0.4%, and school based enterprise training by 0.3%. Further, government enterprise programs increase this probability by 0.4%. Although the scale of these effects is much smaller than for independent business start-up activity, this may reflect the relative difficulty of pursuing entrepreneurial activities within the formalised structures of firms. What it does suggest is that for firms that are undertaking such activities within the context of their businesses the types of people they are more likely to get engaged on these projects are more likely to be those that have access to enterprise training of all forms. Thus our evidence might suggest a positive

dynamic generated by all forms of enterprise training is that firms themselves become more entrepreneurial or at least make use of the people with enterprising human capital.

Owner-manager of a small business

The third measure of entrepreneurial behaviour is being an owner-manager of an existing small business. Here again, we find that receiving enterprise training through a college or university or from a direct government program increase the respective probabilities that an individual is currently an owner-manager of a small business by 2.3% and 3.0% respectively. The scale of these effects is large, and implies that exposure to enterprise training achieves its primary goal of increasing entrepreneurial activity rates. Again, this is consistent with a legacy effect from individuals receiving enterprise training in their life and then using this entrepreneurial human capital at some point in the future.

Future start-up potential

Next, we consider whether or not enterprise training affects an individual willingness in the future to start up their own business. The results on this show that people receiving enterprise training at college or university have a 3.2% higher probability of starting a new business in the future, and that those who have received enterprise training through a government program have a 4.0% higher probability. In addition, those who have had work experience in a smaller business have a 1.4% higher probability. This evidence strongly suggests that exposure to enterprise training, at the minimum, raises peoples' awareness of entrepreneurial activity and instils a more positive attitude towards enterprise as a career option.

Thus far we have found that:

- Enterprise training provided by colleges and universities does generally lead to higher levels of current entrepreneurial activity
- Enterprise training provided by government programs does generally lead to higher levels of current entrepreneurial activity
- Enterprise training provided by schools generally has little effect on current levels of entrepreneurial activity, although it may be too soon to identify these effects
- Work experience in smaller business does not seem to affect current levels of entrepreneurial activity

- All forms of enterprise training and work experience in smaller businesses, with the exception of that provided by schools, appears to change people's attitudes, in a positive way, towards becoming involved in entrepreneurial activity in the future.

Thus the picture presented so far is generally positive in terms of the actual effects of receiving enterprise training on current entrepreneurial activity and the potential future intentions to pursue an entrepreneurial career path. But this portrayal may be slightly misleading if those individuals with the greatest desire, *a priori*, to pursue an entrepreneurial career path, select into enterprise training. Thus it becomes self-fulfilling that those who elect to get training then go on to start their own businesses. Whilst this might be less of an issue in schools, as pupils are not likely to be offered a choice, it may be in colleges and universities, and also on government programs. However, this is not clear cut if enterprise training is course based as part of the standard curriculum, and hence compulsory to attend, and in the case of government programs if, say, the long-term unemployed have little choice but to attend some form of work-based training.

Further tests showed that, on balance, it appears that promoting enterprise in the education system, and via government backed enterprise programs does have the desired policy outcome in that people who received these modes of support are generally more likely to become involved in entrepreneurial activity. It is also the case that gaining work experience in smaller businesses increases an individuals' willingness to become an entrepreneur. But the evidence here also suggests that those who are most likely to pursue an entrepreneurial career also are those most likely to receive enterprise training or gain work experience in a smaller business. There are two arguments that could be put forward here. Firstly, this is good as it provides willing participants with new knowledge and the tools to become more successful when they embark on an entrepreneurial career path. In short, the provision of enterprise training and education acts as a filter to discriminate between the unwilling and unlikely and future entrepreneurs. Thus support naturally gets to those who will make most use of it. But, it may be the case that expanding enterprise training and education has diminishing returns as it becomes harder to convince the unwilling that they have an entrepreneurial future. However, even if there are diminishing returns to expanding the availability of enterprise training and education, it is absolutely not clear that we have reached the point where the returns are negative (i.e., where there is too much enterprise

education and training for the numbers of people who might subsequently benefit). One could argue that as the peak time for starting an entrepreneurial career is typically between 35 and 45 years old, it is a useful addition to the general human capital of any school pupil, further education or higher education institution student.

Having found that enterprise education and training is generally becoming more widely available in the UK, and that this has had an effect on entrepreneurial activity rates, the final question is has it improved quality of entrepreneurs. Here the results do show some positive effects with schools based enterprise education and work experience acting positively on job creation, and college / university and government supported training being associated with greater exporting capacity. These findings suggest that there are positive benefits in terms of enhancing quality of entrepreneurs, and that all modes of enterprise support and informal human capital development have a positive role to play.

At a policy level, it appears that enterprise education is well integrated into the further and higher education system, but as yet not widely available in the school system. If policy-makers are minded to create a continuous ladder of enterprise education starting in schools and continuing on through the education system and into the formal labour market, this patchy provision needs to be addressed at the earliest level, and potentially at later stages, where large regional imbalances are evident in terms of accessing government supported enterprise training. And policy-makers must decide whether they want to target resources at the 'most willing' or adopt a more inclusive agenda which would seek to change mindsets of the 'unwilling'. At present, the impact on quantity is positive, but less impressive than the impact on quality.

Summary

Australia has been a remarkable economic success story over the last twenty years and the population has shared in this success with rising real wages and high levels of employment. It is not untypical for economies experiencing long and sustained growth to experience labour shortages. In a sense, Australia is a victim of its own success. But the backdrop is less rosy. Labour productivity has not been keeping up with real wage growth

and this presents a significant problem going forward as Australia is not immune to external competitive pressures.

The smaller business sector of the economy in particular appears to have a relatively low skills base, and if it is to be the future engine of growth and productivity improvements, then this issue needs to be addressed. On the plus side, the smaller business sector has a huge potential for productivity improvements as it begins from such a low base. In terms of moving towards a more knowledge intensive economy trading in high value added services, the potential is high. Access to knowledge in the wider economy is not an issue. But the absorptive capacity of the smaller business sector is. Here, 308,000 businesses are constrained in their innovation efforts by a lack of internal skills. Yet even more businesses, 391,000, are constrained in their innovation efforts by a lack of skilled labour from the external labour market pool. Quite simply the under-supply of highly skilled knowledge workers, particularly in IT, business, and finance represents a significant drag on the economy going forward. Whilst in the short-term some of this shortfall, or skills deficit can be addressed by an increase in training and skills development within the business sector, in the long-run, the education systems ability to increase and improve the stock of knowledge based workers available for employment in the business sector needs to be tackled.

There is also a strong case to be made for the inclusion of enterprise training at all levels of the education system from early school years through to further and higher education institutions. The potential benefits are large in terms of giving those who would have chosen an entrepreneurial career path better skills and competencies, and for others a general increase in the quantity and quality of the entrepreneurial stock available in the economy. This would help reduce the significant proportion of the entrepreneurial stock of firms in the Australian economy who are operating in a low-skills equilibrium driven, in part, by the entrepreneur's lack of competency and ability to shift their businesses onto a higher skilled, higher value added trajectory.

Regulation without stifling entrepreneurship

In October 2013, the Productivity Commission released its landmark report *Regulator Engagement with Small Business*. The report was the result of a lengthy inquiry in which the Commission sought to benchmark regulator approaches to small business and make recommendations for governments to improve the delivery of regulation and reduce unnecessary compliance costs for businesses.

Regulation is necessary and unavoidable, and the Commission estimated that small businesses in Australia are subject to 480 or so Commonwealth, state and territory regulators, as well as 560 local government regulators. The report reiterated established views that small businesses incur proportionately higher compliance costs compared to larger ones, and that small businesses face great challenges in understanding and fulfilling their compliance obligations.

The IPA made a submission to the Productivity Commission at the inquiry stage, outlining its views on how to improve regulator engagement with small business. Now, having examined the Commission's report in detail, the IPA believes it is timely to present its views on the report – and on how governments should act in response.

The first observation to make about the Commission's report is that its overall judgment of regulators and regulation in Australia is positive – perhaps unexpectedly so. Contrary to widely-held negative perceptions about the impact of regulation on small businesses, the Commission finds that many regulators in Australia are doing a good job – trying to strike a balance between society's need for regulation and the need to avoid imposing unreasonable compliance costs on businesses. The report also highlights how some regulators that might have deserved criticism in the past have been actively working to have a more positive impact. Some corroborating evidence is provided by the ABS Business Longitudinal Database, which shows that on average 87% of business owners between the years 2006-07 and 2010-11 do not perceive that their businesses' innovation and activities or performance are significantly hampered by government regulation or compliance. However, the longitudinal data does indicate that there is a statistically significant negatively increasing perception towards government regulation or compliance over the 5 year period, with 11% of business owners in 2006-07 stating their businesses' innovation and activities or performance are significantly hampered by

government regulation or compliance, increasing to approximately 16% in 2010-11. This demonstrates that there are still major problem areas to which the Minister for Small Business, the Hon. Bruce Billson MP, needs to direct his energies. The report finds that many of the nation's two million-plus small businesses continue to carry unnecessary costs from their dealings with regulators.

A number of insightful submissions to the Commission's inquiry highlighted real-life cases of small businesses – often family-run affairs – being hobbled, and in rare instances crippled, by regulations that are inappropriately implemented, aggressively applied or just poorly designed. Some prominent regulators were singled out for criticism, and myriad other examples were provided of regulator problems for small businesses, ranging from excessive reporting requirements to costly delays in processing licenses and permits.

The IPA, after careful assessment of the report's findings, believes the Minister should give priority to the following areas.

Regulation design and implementation

In its submission to the Productivity Commission inquiry, the IPA advocated for an EU-style 'think small first' approach to the design and implementation of regulations. As we stated, regulations are often written with regard only to the 'big end of town' and a desire to maximise information. This can lead to over-regulation and impose significant burdens on small business. A preferred approach is to identify the minimum required to meet regulatory objectives and how small business can deal with it. It may then be possible to upscale requirements when dealing with big business.

The report brought to light a number of examples of regulations being introduced without due consideration of potentially harsh impacts on small business. It is also important to ensure that in cutting red tape, we don't alter the policy intention but rather we make regulation more effective.

Regulator culture

A large proportion of the report is devoted to issues of regulator culture, and the need to improve the philosophical approaches and engagement methods of those who implement and enforce regulations. The IPA agrees with the findings on the need for governments and regulators to:

- Promote a 'risk-based' approach to enforcement of regulations. In this way, businesses considered more likely to transgress, or businesses whose transgressions would cause the highest costs to society, are supervised more closely than others. This approach encourages both an efficient allocation of regulator resources, and avoidance of unnecessary burdens on businesses that are perceived to be lower risk from a regulatory angle. Many regulators – such as the Australian Taxation Office (ATO) and various food safety agencies – already embrace a risk-based approach. But the report cited others that tend not to, such as liquor regulators and smaller regulators in general. We believe there is scope for much wider adoption of risk-based enforcement, and that governments must take an active role in promoting this.
- Enforce regulations in a proportionate way. The report and some submissions highlighted the tendency of some regulators to take disproportionately harsh measures against businesses that have fallen foul of regulations, often inadvertently. The IPA believes regulators should be encouraged to use discretion in their enforcement role to ensure that small businesses are not unreasonably punished for minor infractions. The empowerment of regulators to make balanced decisions within the spirit of the law will often require cultural change among enforcement officers. The Commission acknowledges the need to avoid industry capture of more empowered officers.
- Put more emphasis on education of small businesses on how to comply with regulations, rather than enforcement and punishment of those who transgress. In cases of minor and inadvertent infractions, enforcement officers should make the education of small business owners their first response. The response should escalate to penalties only with repeat offences. In many cases this will require specific measures by governments and/or regulators to give discretionary powers to officers. We also see an expanded role for intermediary organisations such as the IPA in educating small businesses about their obligations. Ultimately, a more educative approach will reduce both the compliance costs for businesses and the overall rate of transgression.
- In addition, stakeholders continually report that small business is often effectively denied access to government work, partly because of the process and the culture. It is contended that the public sector culture gets in the way and that, for example, it is less risky to appoint a large multinational than an unknown small business. Risk management within government needs to be completely reviewed. Other jurisdictions such as the US may be useful in this context.

Layers of government

Another area of regulatory reform which must be considered relates to the structure of government and particularly the issues which are created by having three layers of government. The potential for waste, duplication and regulatory over-reach cannot be under-estimated. We await the findings from the e Federation White Paper, to be delivered by the end of 2015. The terms of reference state that Australia's Federation has great strengths but duplication and overlap between different levels of government results in waste and inefficiency. It should also be noted that the Federation White Paper was to have been coordinated with the White Paper on the Reform of Australia's Tax System. In the meantime, it is interesting to note that the specific area of local government reform has and is receiving a huge amount of attention. The 'Review of Current Local Government Reform Processes in Australia and New Zealand in 2013 by the Australian Centre of Excellence for Local Government found there were nearly 30 review and reform initiatives currently underway. These covered, inter alia, financial reforms, functional reforms, jurisdictional reforms, organisational and managerial reforms and structural reforms. It is also insightful to consider the work of the Productivity Commission including the 2012 report Business Regulation Benchmarking: Role of Local Government as Regulator, and the rest of the benchmarking series into business regulatory burdens. However, the question remains - despite the attention and reviews, what has been achieved in terms of actual, implemented reform. We note that some work is being done around capturing and measuring case studies. Specific examples which have been provided to the IPA include why we need to recreate certain regulations around such things as chemicals and drugs; if the US FDA approves an item, why can't we apply a principle of mutual recognition. Another example is licensing schemes and why some such as liquor licensing need to be renewed annually (which goes back to the gold rush). Annual licensing should be considered across a range of areas to see whether it is warranted or can be appropriately changed to a longer period. All of this involves greater engagement with small business.

Other areas of regulation

We acknowledge the work of the Government and its deregulation agenda which aims to cut red tape compliance by \$1 billion per annum. The aim is to achieve this through strengthened regulatory impact analysis and quantifying compliance costs, audit of the stock of regulations, improved regulator performance and so on.

The IPA and other stakeholders must hold government and its agencies to account and to support and play our part in achieving this ambitious target.

Taxation

Headline findings

- As there is a myriad of definitions of small business with multiple inconsistent criteria, definitions and thresholds, there should be a holistic approach to the definition to create a more broadly applied definition of small business.
- The reluctance by small businesses to employ people is attributable to compliance obligations imposed on entities associated with employment such as PAYG, Superannuation Guarantee Charge, FBT and workers compensation, which impose substantial costs and when combined with other nontax regulations impose disincentives to employing staff.
- The eligibility rules related to small business CGT concessions are overly complex and should be simplified. These rules impact closure of small businesses.

A tax system that supports small business growth

The IPA is strongly of the view that immediate and tangible incentives must be offered to entrepreneurs and innovators, to encourage their entry into, and long term engagement with, the Australian small business sector. The Federal Government needs to implement policies that will drive business activity and entrepreneurialism across all sectors.

In particular, we believe significant economic growth will occur if there is a more supportive regulatory environment, and tax policy is a critical part of the regulatory environment for small business owners. A vibrant economy is heavily dependent on its small business sector.

Due to the highly regressive nature of compliance costs on small businesses, there is a strong argument for concessional tax treatment. Small business, as with large business, has a plethora of reporting obligations. However, unlike large business which is usually better resourced to deal with the multitude of reporting requirements, the cost of compliance for small business is disproportionately higher. Government reports that small business spends up to five hours per week on compliance with government regulatory requirements.

This requires an examination of tax impediments for small business and a consideration of appropriate policy responses.

There are various other tax issues relating to small business; a major concern for small business is around tax and succession, which has been explored in other jurisdictions including New Zealand and the EU.

Whole of government approach to definition of small business

There should be a whole of government (both federal and state) approach to the definition of small business. There is a myriad of definitions of small business with multiple inconsistent criteria, definitions and thresholds. The process by which tax laws identify small business needs to be as consistent as possible to reduce the amount of complexity and the compliance burden on small business. However, there does not appear to be agreement during consultation for a more broadly applied definition of small business. It is acknowledged that when it comes to definitions of small business that one size definitely does not fit all situations.

Compliance burdens in respect of employment

A significant number of small businesses do not have employees. Whilst most are one person businesses, the issue of why there is reluctance for small businesses to employ people would in part be attributable to compliance obligations imposed on entities associated with employment. Some of the compliance burdens are tax related such as PAYG, Superannuation Guarantee Charge, FBT and workers compensation. These compliance burdens impose substantial costs of time and money which when combined with other nontax regulations impose disincentives to employing staff.

Small business CGT concessions

The small business CGT concessions are overly complex. Whilst the rules were subject to a post-implementation review by the Board of Tax, the eligibility rules need to be simplified. Their complexity in part is due to having to deal with multiple business structures and anti-avoidance provisions. There is an opportunity to rationalise and streamline the CGT concessions which has also been recommended by the Henry Review. The four current and separate small business CGT concessions require taxpayers to navigate complex legislation. These concessions impede the efficient transfer or closure of small businesses.

A more supportive regulatory environment for start ups could help address one of the main challenges of attracting and retaining experienced skilled employees faced by start ups. We acknowledge that the Government is introducing legislation to reverse the 2009 changes and to restore employee share schemes (ESS) in a viable and credible format. A more favourable ESS regime could also greatly assist established businesses with succession planning as it would make offering shares to employees more attractive.

There is widespread support for these proposed changes to the ESS; including on the basis of assisting with succession planning (which is a particularly huge issue for family businesses wanting to pass on the business to employees), growth with employee buy-in, start ups and so on.

Simpler structure options for small business to streamline and reduce regulation and red tape

Multiple structures are commonly needed to achieve tax outcomes which would be otherwise unavailable through a single entity. A simplified small business entity regime can significantly reduce regulation and red tape for small businesses.

Small businesses seek measures which promote asset protection, the retention of profits for working capital, lower tax rates, access to CGT discounts, succession planning and income distribution. A combination of entities is generally used to achieve these outcomes. A typical example may be where a business operates through a partnership whose interests are held by a discretionary trust with a company amongst the trust beneficiaries. When a small business operates through separate legal structures; the current taxation system treats the structures as taxation entities separate from their owner(s); resulting in a quantum leap in tax compliance and complexity.

International evidence exists of entities specifically designed for small businesses. For example in the United States, small businesses may set up using an S-Corporation that offers a number of advantages such as asset protection and flow through tax treatment.

The creation of a new small business structure allows small business entities to use a single simplified structure rather than the current complicated ownership structures such as trusts.

If such a structure allowed the retention of income at the corporate tax rate, it would allow most of the benefits that can currently be obtained via the use of a company and discretionary trust via a cheaper and simpler vehicle to administer. A simpler structure option could represent a better pathway to avoid the complexity that exists in relation to Division 7A and trusts.

We suggest a separate type of entity be established specifically for small business with attributes of various existing structures that make it attractive for small business taxpayers to use. Ideally, business profits that are reinvested in a business should be taxed at a uniform corporate tax rate as other entities are able to reinvest at least 70 cents of each dollar of profit back into the business.

As an impetus for taxpayers to use this structure the small business concessions could be restricted to such 'small business entities'. There could also be appropriate and simple integrity rules to ensure against misuse.

If such a structure was sufficiently attractive for small businesses to use, it could result in much lower compliance costs.